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SUBJECT: AFGHANISTAN: IMF MISSION GIVES DOWNBEAT ASSESSMENT

SUMMARY

11. (SBU) An IMF staff mission has conducted the fifth review of Afghan performance under the Poverty Reduction and Growth Fund (PRGF) program and found shortcomings. Their overall message was that GIROA performance under the program, especially its fiscal aspects, is slipping and political-level support for it waning. Staff also raised concern about the health of the Afghan banking system and welcomed continued US assistance to strengthen supervisory capacity at the central bank. The team said it will require the GIROA to fulfill two prior actions relating to fiscal performance before it will recommend IMF Board completion of the review, tentatively planned for February 2009. They expect implementation of these prior actions will be difficult, so postponed completion of the review is a possibility. End Summary.

GDP GROWTH SLOWS; INFLATION MODERATES

12. (SBU) IMF staff forecast growth in real GDP for the Afghan fiscal year ending in March 2009 will be 3.0 to 3.5 percent, down from an earlier forecast of 7.5 percent and actual growth last year of 11.5 percent. The sharp deceleration was due to a double-digit decline in agricultural production this year, caused by drought. Growth in non-agricultural output remains robust, estimated at 12 percent. Inflation declined from its peak of 40 percent (March 2008 over March 2007) to 25 percent now, and Fund staff expect the March 2009 price level to be about 20 percent over March 2008. Staff said they are not concerned about inflation.

POOR FISCAL PERFORMANCE

13. (SBU) IMF staff expressed concern about deteriorating Afghan fiscal performance, on both the revenue and spending sides, only a small part of which could be attributed to factors outside Afghan control. Both problems are due in large part to a lack of government support outside the Ministry of Finance for revenue

generation and restrained spending. As a result, the GIROA will have low cash balances at the end of the fiscal year in March, and could face arrears on current obligations such as civil service salaries unless it increases revenues or cuts expenditures. In fact, it has been raising expenditures without a clear idea where the money will come from. Fund staff said the GIROA would face a deficit in its operating budget including grants for the next two years.

14. (SBU) Spending. IMF staff said the GIROA hopes donors will cover the increase in teachers' salaries, equal to some \$43 million. But the Ministry of Education did not administer to donors' satisfaction a test of basic literacy and numeracy skills meant to weed out unqualified teachers, which was a commitment to justify the donation. Indeed, in a meeting on December 15, Finance Minister Ahady urged donors to shift funds from development projects (e.g. building schools and purchasing text books) to cover higher teacher salaries. Donors were unenthusiastic and complained that the salary increase was granted even though unqualified teachers have not been let go.

15. (SBU) Additional spending pressure comes from GIROA purchases of imported fuel used to subsidize DABM, the electricity utility, and \$100 million to buy wheat, which the GIROA is expected to give away. IMF staff said that there is some evidence the GIROA recognizes the need to rationalize spending, but they do not expect the government to take many tough decisions before the 2009 elections.

16. (SBU) Revenues. At the current pace of revenue collection, the GIROA will miss PRGF revenue targets for the third quarter of Solar Year 1388 (ends December 21) by roughly 15 percent. At the time of

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the fourth PRGF review, the IMF agreed to reduce the revenue/GDP performance target for this fiscal year from 7.5 percent to 7.0 percent. Now Fund staff say Afghan performance will fall below even the reduced target, and a revised target remains under negotiation with the GIROA.

17. (SBU) Staff were also disappointed that customs revenues declined in nominal terms in the first seven months of this fiscal year, compared with the same period last year, even though inflation and the value of imports were up. (Note: Total revenues increased in nominal terms but are still well below the program target.) Staff said corruption in the Fuel and Liquid Gas Enterprise (FLGE), the government-owned fuel importer under the Ministry of Commerce and Industries, was responsible for a sharp decline in customs revenues from the northern border port of Hairatan. They called for a change in FLGE leadership (see para 14). Since customs revenues make up 40 percent of total GIROA revenues, the Fund puts special emphasis on the weak performance there.

18. (SBU) Taxation of airlines, especially private carrier KamAir, is the other big revenue issue. KamAir alone among private airlines has refused to pay taxes in recent months. MOF has been unable to win cooperation from the Transport Ministry to ground KamAir, while banks have refused to comply with MOF's attempts to garnish KamAir's bank accounts. Reportedly under lobbying from owner Zamirai Kamgar, the President has established two committees under his office to look into airline taxation issues. One committee is determining whether GIROA should waive KamAir's back taxes as compensation for KamAir's losses from the 2007 Hajj operation. The other committee is studying a proposal to reduce airlines' Business Receipts Tax from 20 percent to 10 percent. IMF staff argue that both committees erode the authority of MOF to decide tax policy, and could lead to reduced revenue just when GIROA badly needs cash.

CONCERNS ABOUT AFGHAN BANKS

19. (SBU) IMF staff expressed concern about the health of Afghan commercial banks and see an urgent need to strengthen the central bank's (DAB) supervisory capability. They cited the collapse last month of a small bank, Development Bank of Afghanistan (DBA), which resulted from supervisors not seeing problems in time and giving owners too many chances to fix them. Now that it has collapsed, DAB supervisors are absorbed in the clean-up and not paying enough

attention to the health of larger Afghan banks. Any problems at the larger banks would be harder for DAB to handle and have greater systemic impact.

¶10. (SBU) Eighty-five percent of Kabul Bank's assets are loans, mostly overdrafts without a fixed repayment schedule (it is currently in the process of converting overdrafts to fixed-term loans). It would be hard pressed to deal with any panic by its 500,000 depositors. At Azizi Bank, a more comfortable 60 percent of assets are loans, but the bank's shareholders -- and possibly the loan portfolio -- are heavily exposed to problems in the Dubai property market. Both of these banks say they are taking steps to improve credit assessment and internal auditing, and DAB has increased regulatory requirements since the DBA collapse. IMF staff do not see signs that the Afghan banking system faces a funding crisis, as was reported in the international press recently, but note that the health of banks is hard to judge because of weakness in supervisory capacity.

¶11. (SBU) The IMF Mission met December 15 together with DAB Governor Fitrat, USAID and Treasury to discuss the state of capacity building efforts within banking supervision. The IMF and DAB expressed satisfaction with USAID's plans to continue to provide advisors to improve the DAB's supervision capacity. A new salary and incentive

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structure is now in place, and should help reduce the high turnover the department has experienced. Governor Fitrat also outlined steps that DAB is taking to strengthen banking supervision, including a reorganization of the department and the hiring of 15 new college-educated bank examiners, bringing the department's total staff to 50.

BOTTOM LINE: TOUGH PRIOR ACTIONS REQUIRED

¶12. (SBU) Fund staff said the patience of IMF Board members was fraying, as poor Afghan performance postponed the arrival of fiscal sustainability. For this reason, before recommending completion of the fifth PRGF review, staff will insist on GIROA fulfillment of two prior actions meant to improve government finances in the fiscal year starting next March. First, the government must apply the Business Receipts Tax to imports, either by legislative enactment or Presidential decree. Second, it must implement the MOU between the Finance and Commerce ministries on access by Customs officials to FLGE fuel depots, to check quantities and reduce corruption.

¶13. (SBU) IMF staff said these steps are required to show GIROA resolve to improve fiscal performance but will be difficult to implement. A prior action for the fourth review was signing the MOU on depot access, but nothing beyond signature has been done. If the GIROA does not fulfill these two prior actions, completion of the fifth review will be postponed. Staff hope that the prior actions are completed in late January or early February, allowing the fifth review to come before the IMF Board by late February. Staff said that in the event of an extended delay the PRGF could be extended for up to one year. This, in turn, could affect action at Afghanistan's HIPC completion point, planned for June 2009. Staff said they did not discuss a possible successor program with the GIROA during this review but would plan to during the sixth (and final) review.

¶14. (SBU) According to the IMF and Minister Ahady, Minister of Commerce Farhang has pledged cooperation from his ministry in implementing the MOU on fuel depots. However, there are reasons to doubt that progress will be forthcoming. The MOU would presumably deprive the powerful head of FLGE, Engineer Rozi, from collecting payments from fuel importers in exchange for his help in avoiding customs duties. It is unclear whether the Minister of Commerce has the political weight to constrict the activities of Rozi or remove him from power. The MOU will focus on FLGE activities at the Hairaton border crossing with Uzbekistan, the entry point for roughly 70 percent of fuel imports into Afghanistan. (Late breaking news: Minister Farhang was impeached by the Parliament on December 20).

COMMENT

¶15. (SBU) Staff observe weak support from the Palace and other ministries for MOF efforts to raise revenues and meet IMF fiscal targets. The ability of GIROA to keep the IMF program on track will depend on the support of President Karzai and the rest of the Cabinet for the reforms pursued by Minister Ahady. In a closed-door meeting with the IMF attended by Treasury Attache, Minister Ahady acknowledged "the disconnect" within GIROA on its reform program and commitments to the IMF. Referring to his recently submitted resignation letter, Ahady said he agreed to stay on as Finance Minister only after receiving a pledge from President Karzai to back the revenue collection effort and other reforms. Ahady says he plans to take the IMF commitments to the "president and Cabinet," and "tell him to find someone else" for Finance Minister if support is not forthcoming.

¶16. As of December 22, Ahady's advisors reported that he is close to

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resigning. In addition to the perceived lack of support for economic reform and revenue generation, Ahady is frustrated with President Karzai's refusal to remove the Deputy Minister of Finance, Wahidullah Shahrani, with whom Ahady has had a running feud during the last year.
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